

ADVISORY COUNCIL ON AGRICULTURE, LABOR AND
SMALL BUSINESS

Chicago, Illinois
March 12, 1999

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- I. Good morning. Thank you for being with us today.
 - A. Appreciate willingness to share time and insights.
 - B. Hope meetings this morning went well.
 - C. Like to present an overview of FOMC actions since we last met in September.
 - D. Key question during our discussions in September was how overseas developments would affect our domestic economy.
 - E. FOMC had just returned to an 'unbiased policy position'. That is, Committee members had decided that they were just as likely to tighten policy as they were to loosen.
 - F. Over the previous summer, inflation had declined despite strong domestic demand and tightening labor markets.
 - G. Because of the need to anticipate inflationary pressures before they show up in the numbers, the FOMC had allowed the real fund rate to rise.
 - 1. That is, FOMC held nominal federal funds rate unchanged.
 - 2. Due to declines in inflation, this meant real rates rose.
 - H. So, heading into August, policy was a bit on the tight side although, as I said, the FOMC had officially just returned to an 'unbiased policy position'.

II. By the time of our last meeting, conditions abroad had worsened, affecting the US outlook due to the uncertain situation overseas.

A. Turbulence abroad.

1. Triggered by the Russian crisis.
 - a. In mid-August, Russia suspended payments on domestic debt.
 - b. As IMF stabilization program was suspended, ruble was devalued.
 - c. Surprised investors fled.
 - d. Ruble depreciated again, sharply this time.
2. Instability spread to other emerging market nations.
3. Instability in global financial markets.
4. East Asia crisis remained a drag on the economy.

B. Back in the US, investors perceived increased uncertainties in the markets and became more risk averse.

1. Demand for US Treasury securities increased – safe haven.
2. Demand for private debt securities eased.
3. Dramatic pulling back from risk.
4. Risk spreads at historically high level.
5. Capital markets tightened.
6. Business borrowers turned to commercial banks.
7. Commercial banks tightened lending standard and terms.

C. FOMC became concerned that credit-worthy borrowers might be denied access to credit, even for productive investment opportunities.

III. FOMC reaction:

A. First rate cut was a $\frac{1}{4}$ percentage point on September 29

1. Three policy easings within eight weeks.
2. By November, the federal funds rate had dropped to $4\frac{3}{4}$ from $5\frac{1}{2}$ percent.
3. Financial markets recovered, although some risk spreads remain elevated.

III. When FOMC took action in fall, there was a risk of a slow down. Now situation is in fact more balanced, as Charlie Evans' presentation will address.

- A. Economy's underlying momentum continues to express itself in real GDP rates.
 - 1. Fourth quarter 1998 annual rate exceeded 6 percent.
 - 2. In first quarter 1999 labor markets remain tight and the economy appears to be retaining underlying momentum.
 - 3. At the same time, recent strong growth in spending is likely to trigger inflationary pressures without significant further increases in productivity growth.
- B. Down side risks to the economy. *(This section will be covered by Charlie Evans and can be dropped if you like)*
 - 1. Increasing debt in household and business sector's as well as dramatic rise in US current account deficit.
 - 2. Future outlook for the stock market and the implications for business and consumer spending.
 - 3. Conditions overseas remain uncertain.
 - a. Recent troubles in Brazil, for example.
 - b. As you know, overseas situation has affected agriculture and certain manufacturing industries.
- C. Given the situation, monetary policy will need to be prepared to move quickly in either direction.

IV. We have our next FOMC meeting on March 30.

- A. I am interested in hearing about your discussions yesterday.
- B. Charlie Evans will now provide us with an overview of the current economic outlook.